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SUBJECT: TURKISH MARKETS END YEAR ON BULLISH NOTE

11. (Sbu) Summary: Despite news that would normally buffet the market--in both directions--Turkish debt and foreign exchange markets have been notably calm, with a positive trend in recent weeks. In thin trading close to the year-end balance sheet date, interest rates on GOT debt have gradually declined in a narrow range while the lira has gradually strengthened. The more volatile stock market has continued its 2003 rally to reach a three-and-a-half year high. But even the stock market has not been prone to the sharp movements that were common earlier in the year. End Summary.

Lots of news--little volatility:

12. (Sbu) There has been an abundance of potentially market-moving news in recent weeks, both negative and positive: the deadlocked Cyprus election results, IMF Board Approval of the Sixth Review, the forced resignation of the bank regulatory board Chairman, the passage of the 2004 budget, and increasing indications that the GOT will hit or come close to its year-end growth, primary surplus and inflation targets. In recent days, there have also been signs of renewed GOT attempts to throw out populist bones, such as the above-inflation increase in the minimum wage or the proposal to remove names from banks' list of bad creditors.

13. (Sbu) While none of these events would be expected to cause huge rallies or dizzying falls in the markets, in earlier months they might have caused sharp movements. Instead, in recent weeks, markets have tended to take everything in stride, either trading sideways or moving gradually in a positive direction.

Interest Rates Continue their Long, Downward March:

14. (Sbu) The market for government securities, for example, despite a heavy calendar of debt redemptions and issuance, has continued to experience a slow but steady decline in yields, as inflation expectations and, perhaps, the Turkish government's risk premium, gradually come down. The interest rate on the benchmark bond, for example, declined from 28.54 percent on December 5 to 25.63 on December 30. Unlike earlier this year, the rates rarely moved back up--or fell sharply--but tended to trend down very gradually.

Lira Stays Strong:

15. (Sbu) The Turkish lira continues to defy gravity. While economic theory would suggest that a high-inflation country's currency cannot maintain or even increase its nominal value for a sustained period, the Turkish lira has done exactly that over the past nine months. As previously reported, local analysts have attributed the lira strength to a combination of reverse currency substitution--i.e. Turks moving foreign exchange holdings into lira--foreign portfolio investors and inflows from Iraq. With most economists expecting a nominal decline in the exchange rate sooner or later, the persistence of lira strength in December is notable.

16. (Sbu) Since December 5, the dollar has declined from TL 1.444 million to TL 1.401 million December 30, and was trading below TL 1.4 million during morning trading December 31. Most of the decline in the nominal TL/dollar rate is attributable to the sharp decline in the dollar/euro rate in

recent weeks, as can be seen by the much narrower range in which the TL is trading against the Euro: TL 1.748 million on December 5 and TL 1.746 million at the close December 30. (In between these two dates, the Euro strengthened slightly against the TL, but overall has been relatively stable). Though the Euro rate is in some ways a more meaningful indicator since Turkey trades far more with Euroland countries than with dollar or dollar-linked countries, the lira-dollar rate has important psychological value here. Also, against a basket of its trading partners' currencies, the lira is still appreciating slightly in nominal terms, and substantially in real terms.

17. (Sbu) One veteran local market-watcher and a Central Bank official separately told Econoff that the strengthening of the lira in the past few days is due to lira demand to make year-end tax payments and, especially, due to heavy lira purchasing by Turkish banks. Both noted that a stronger lira helps banks' year-end balance sheets, though the Central Banker stopped short of the private analyst's allegation of market manipulation by the banks. According to the Central Bank official, Turkish banks went long in foreign exchange in October and November, expecting the decline in the lira to continue. Since that has not happened, and the markets are generally quite optimistic about 2004, the banks have piled back into lira in recent days. He noted that the Bank buying was strong enough to counteract substantial lira sales by oil refiner Tupras and pipeline company Botas in recent days. The Central Bank official added that the Bank is considering resuming the foreign exchange purchases it stopped conducting two months ago. But rather than act based on thin and quirky year-end trading, the Central Bank will probably await next week to take a decision.

Equity Market Continues to Hit New Highs:

18. (Sbu) Though it has been less volatile than earlier in the year, the stock exchange has continued to move in a positive direction. Even after the market-worrying Cyprus election deadliock, the stock exchange hardly reacted. Overall, the cumulative rise over the past three weeks has been impressive: the IMKB 100 index rose from 16,913 December 5 to 18,541 at noon on December 31, a ten percent increase. The stock exchange is now at a three-and-a-half year high.

Comment on Volatility:

19. (Sbu) The Central Banker agreed that the market seems to ignore bad news and move up on good news, but that Turkish markets are noticeably less volatile. It's not yet clear whether factors unique to the year's end are the principal reason for the volatility or whether something more fundamental is at hand that could continue into the new year. At least in part the lessened volatility seems to be linked to a perception of increased stability in the Turkish economy, leaving market participants less inclined to bolt or buy at the slightest news.

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